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Helping clients cut through the fog of complexity

August 2017

When choosing the best investment solution for your organization, you face a formidable task. Already confronted with thousands of investment options, you’re seeing more complex products, many in response to what’s expected to be a low-return environment. These include mutual funds that incorporate leverage in new ways, target-date funds (TDFs) that invest in alternatives, and customized TDFs with glide paths unique to your plan’s participant demographics.

Distinguishing innovation from marketing spin can be difficult. We can help with analysis and thought leadership driven by a desire to do what’s right for our clients. As an organization owned by its funds, which are in turn owned by its shareholders, we’re uniquely committed to investor success.

It’s that commitment that’s behind the launch of this investment newsletter. Intended to provide transparency into the review and analysis we conduct of the investment methodology behind our products and services, we hope the articles will help you make your own investment choices.

In this inaugural issue, we pull back the curtain on the robust debate that takes place within our Strategic Asset Allocation Committee, which has responsibility for the investment methodology that guides our single-fund investment solutions and advice programs, including Vanguard Target Retirement Funds. Our CEO, Bill McNabb, writes about how, even in a rising-rate environment, bonds are an important part of a diversified portfolio. We also hear from Vanguard experts in a number of topics, including the potential pitfalls of incorporating alternatives into retirement plans and our approach to active management.

We are confident these articles and those in future issues of this newsletter will help you filter out the noise—to separate those investments that are truly sophisticated solutions from those that are complex simply for the sake of being complex.

Sincerely,

Martha King

Ms. King is managing director of Vanguard Institutional Investor Group.
Questioning retirement plan design in an ever-complex environment

Insights from Vanguard’s head of Enterprise Advice

Shifting regulatory sands, low expected returns, and an aging population may pose problems for retirement plan sponsors, but participants still expect you to help them meet their retirement goals.

You still must determine the proper fund lineup, assess the effectiveness of a qualified default investment alternative (QDIA), and evaluate the suitability of choices through robust analysis and ongoing due diligence.

To better help you meet these and other responsibilities, Vanguard launched Defined Contribution Advisory Services (DCAS) in April 2016—part of an effort to deepen Vanguard’s consultative dialogue with investment decision-makers in the defined contribution (DC) market, said Kevin Jestice. We asked him about DCAS and other topics, including customized target-date funds (TDFs) and considerations for incorporating active management into retirement plans.

**Vanguard:** Why did we launch DCAS?

**Mr. Jestice:** We hear a lot of questions around customization of TDFs, though few plan sponsors are moving to adopt custom funds. We hear a lot of questions around investment lineups: What’s the right way to build a menu? What are the right funds to have? How many funds do I need? We formed DCAS to help our clients think through these questions.

**Vanguard:** What are some of the questions we’re getting around TDFs?

**Mr. Jestice:** How worthwhile is customization to a plan, given the plan’s demographics? What are the real costs and benefits of customization, and how would one approach it? We built a new platform [Vanguard Glide Path Solutions™ (Vanguard GPS™)] to help answer these questions.

And we built the system to be agnostic. However, if you go into [Vanguard GPS] and build a custom TDF, what you find out is that the incremental costs relative to our Target Retirement Funds may be higher than the benefits. Clients are able to model and test things that they hear about and see for themselves.

**Vanguard:** Beyond TDFs, what are some of the issues that are top of mind for clients?

**Mr. Jestice:** We are beginning to see plan sponsors talk about trimming fund lineups in the third tier. [Vanguard suggests retirement plans cluster investments into three tiers: target-date,
core index, and supplemental.) There are fewer dollars there, yet much of their time is spent on oversight of that tier because that’s where the active managers are. That’s where the underperformance and outperformance is. That’s where active manager turnover and succession planning must be considered. A lot of time and energy is spent in due diligence and oversight of tier three, and yet the majority of assets, and definitely cash flow, are heading toward the target-date and index tiers.

It’s still an early-stage trend, but plan sponsors are saying, “We have 20 or 25 investment options in our plan. Let’s bring that down a little. I’m not sure that’s serving our investors that well.”

**Vanguard:** Do you see the third tier eventually going away?

**Mr. Jestice:** There’s a minority of plans that say, “I’ve got target-date funds, I’ve got some broadly diversified index funds and money markets for a cash account. That’s it.” It’s a very simplified, streamlined approach.

But there are still a lot of participants who want to pick their own investments, pick their own managers, and have an active bent. That tier three enables participants to do that. You have to know the participant demographics to understand if you have a workforce that really values that. There are demographics of employees who aren’t interested and don’t use it. That’s a plan sponsor decision. The trend we’re seeing is that plan sponsors are interested in reducing the total number of funds to reduce the due diligence time and resources spent on what is a shrinking percentage of the total plan assets.

**Vanguard:** Investors have been favoring index funds for some years now, and the trend seems to be accelerating. Is there still a place for active management?

**Mr. Jestice:** We certainly think so. This is much more about low cost than active versus passive. I strongly believe that active and passive can play a role in an investor portfolio.

**Vanguard:** How do we advise sponsors considering active management?

**Mr. Jestice:** We want to make sure participants have the ability to construct broadly diversified portfolios. If you’re trying to build a nine-box-style tier three, then you need to fill more of the boxes than not. You can also take an alternative approach that says, I just want a few broadly diversified active U.S. equity funds, international equity funds, and fixed income funds.

Of course, with any active approach, it is also important to have conviction in the manager. This requires that a committee spend time understanding the approach. DCAS works with Vanguard’s Portfolio Review Department to help committees with this, particularly for Vanguard’s active funds.

The thing we have to have in the back of our minds is that a lot of people may employ heuristics to choose funds, which may not be optimal. For example, some investors follow the “1/n strategy” to allocate their portfolios.

They look at the fund lineup, and if there are 20 funds, they might invest 5% in each. I think it’s hard for us sometimes as professionals to understand, but that’s actually a fairly common heuristic in 401(k) savings.
It’s still an early stage trend, but plan sponsors are saying:

“Hey, we have 20 or 25 investment options in our plan. Let’s bring that down a little. I’m not sure that’s serving our investors that well.”

Kevin Jestice

Is that the way we would recommend constructing a portfolio? Perhaps not. Well, then, why would you construct the lineup that way? So, in working with sponsors, DCAS overlays participant heuristics. What does the noninvestment professional see when they look at your plan? That’s part of the conversation we can have. Here are a few views of your plan lineup. It’s not just “Members of the committee, senior executives, what options do you want in your plan?” When the average employee in the company looks at this lineup, what do they see? How are they making decisions?

Vanguard: How do we advise sponsors considering alternative investments?

Mr. Jestice: I think in the DC world, most things need to be tradable daily and have daily liquidity. Not all alternatives provide liquidity appropriate for a DC plan.

The other issue is the due diligence required of a plan sponsor. How much time does the defined contribution committee want to spend doing due diligence on private real estate or private equity deals? And how high a fee is appropriate in an employee savings vehicle? What’s the time horizon of the employees in that savings vehicle?

The segment of the market where we see the greatest use of alternatives is among endowments and foundations. Many have an infinite time horizon and a sophisticated investment committee making decisions for the portfolio. Risks are borne by the institution. There’s a limited liquidity need.

Let’s contrast that to the participant. They likely have constant money flowing in and out of biweekly paychecks and might want to make withdrawals periodically. You need some kind of liquidity lever when they want to withdraw.

Keep in mind, participant decisions are not made by and large by professional, sophisticated people sitting on committees, but rather by individuals who have day jobs outside of investment management. The risk is borne by the individual, not by the institution. The institution can take tail risk. The participant may be the tail risk. They don’t get to spread this risk over a large volume of dollars. What’s in the retirement plan for most people is the lion’s share of their nest egg. So if something bad happens, it’s happening to them directly. They aren’t looking at a dispersion of outcomes. They are an outcome.

Kevin Jestice, CFA, CIPM

Mr. Jestice is past head of Vanguard Institutional Investor Services. In July, he was named head of Enterprise Advice.
Preserving a source of

diversification:
Why we hedge currency risk of non-U.S. bonds

In the world’s largest asset class, the $24 trillion international bond market, Vanguard hedges. Specifically, we hedge our U.S. shareholders’ currency exposures, as completely as possible, back to the U.S. dollar.

Currency hedging is unusual. Only a handful of competing fund providers—accounting for less than 5% of the assets under management in U.S.-domiciled global bond mutual funds and ETFs—seek to partly or totally mitigate the effects of exchange-rate fluctuations on their shareholders’ total returns.1

We were confident when we launched our first international bond fund in 2013 that hedging its currency risk was the right way to go, even if the practice was rare. We were so sure of the long-term merits of dollar-hedged international bonds that we immediately allocated to the new fund 20% of the fixed income portions of our Target Retirement Funds (TRFs), the most prominent of our managed-allocation products and services.2 Our conviction has persisted. Indeed, in 2015 we raised the allocation to 30% of our TRFs’ fixed income holdings.

“In considering any potential change to investment methodology and advice, our Strategic Asset Allocation Committee seeks reasons to believe that the move could enhance long-term returns or curb risks at the overall portfolio level,” said Joe Davis, Vanguard global chief economist and head of our Investment Strategy Group, who chairs the committee.

The committee sets our investment policy and includes a dozen Vanguard principals, our most-senior investment experts, who average 20 years of industry experience, 17 of them at Vanguard.

“Declines in the costs of currency hedging since the 1990s helped to convince the committee that the 2013 addition of currency-hedged international bonds would benefit long-term investors,” Mr. Davis said. “And we believed that exposure to international bond issuers would bolster diversification, thereby trimming risk.”

Letting bonds be bonds
The decision to hedge the exchange-rate risk of our international bond exposures owes to our emphasis on diversification at the overall portfolio level, said Fran Kinniry, Vanguard head of portfolio construction and member of the Strategic Asset Allocation Committee.

“The role of bonds, in the context of a balanced portfolio, which also includes stocks, is to truncate volatility,” said Mr. Kinniry. “With their exchange-rate risk hedged, international bonds

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1 Source: Vanguard calculations, based on Morningstar data as of May 31, 2017.
2 Other all-in-one Vanguard funds and advice services that reflect our asset allocation methodology include target allocation and balanced funds, 529 college savings plans, institutional and retail advisory services, and ETF model portfolios. Worldwide, such funds and services accounted as of June 30, 2017 for more than $650 billion (USD) of our assets under management.
Notes: U.S. stocks represented by Dow Jones U.S. Total Stock Market Index through April 2005, MSCI US Broad Market Index through June 2013 and CRSP US Total Market Index thereafter; REITs by FTSE NAREIT Equity REIT Index; commodities by S&P GSCI Commodity Index; high yield bonds by Bloomberg Barclays U.S. Corporate High Yield Bond Index; emerging markets bonds by Bloomberg Barclays EM USD Aggregate Index; investment-grade corporate bonds by Bloomberg Barclays U.S. Corporate Index; U.S. Treasury bonds by Bloomberg Barclays Global Aggregate ex-USD Bond Index; international bonds by Bloomberg Barclays Global Aggregate ex-USD Bond Index. Bloomberg Barclays EM USD Aggregate Index starts in January 1993; and Bloomberg Barclays Global Aggregate ex-USD Bond Index starts in January 1990. All data provided through December 31, 2016.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Notes: International stocks are represented by the MSCI World ex USA Index through 1987 and the MSCI All Country World Index ex USA thereafter. International bonds are represented by the Citigroup World Government Bond Non-USD All Maturities Index through 1990 and the Bloomberg Barclays Global Aggregate ex-USD Index thereafter. All data provided through December 31, 2016.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.
“Declines in the costs of currency hedging since the 1990s helped to convince the committee that the 2013 addition of currency-hedged international bonds would benefit long-term investors.”

Joe Davis

The adjacent charts tell the story, as it has played out in recent decades. Amid the sharpest U.S. equity declines, as shown in Figure 1, hedged and unhedged international bonds have delivered similar gains, with hedged international bonds experiencing roughly the same return variability as U.S. Treasury and corporate bonds. However, currency moves have made unhedged international bonds much more volatile than hedged international bonds (see Figure 2). The trend has continued in more recent years, with the volatility of hedged international bonds being low and virtually identical to the volatility of investment-grade U.S. bonds.3

Over longer and shorter periods, then, currency-hedged international bonds have exhibited the kind of modest volatility that U.S. investors generally expect from investment-grade U.S. debt.

Declining hedging cost helped spur change

Vanguard has estimated that the transaction costs to hedge the currency risk of an international bond portfolio is less than 20 basis points per year.4 Trading costs in that market can be difficult to measure precisely and vary over time, often in response to changing market conditions, said Jeff Johnson, Vanguard head of Fixed Income in the Asia-Pacific region. However, he said hedging costs accounting for about two-thirds of overall transaction costs for an international bond portfolio would be a reasonable estimate.

Ultimately, Mr. Johnson said, the best measure of our currency hedging efforts is in the relative performance of our international bond index funds. In order to tightly track our benchmarks, which as theoretical constructs are cost-free, we try to minimize hedging costs through sophisticated trading and portfolio management. To do so, we employ a foreign exchange team with experienced traders in three global sites. Each maintains strong local market knowledge and, because they are in those markets, are able to obtain best execution for the currencies they trade “in the time zone.” This would be much harder if we didn’t have a strong global presence with experts in the market in multiple locations globally.

3 The annualized standard deviation of the monthly returns of the Bloomberg Barclays Global Aggregate ex-USD Float Adjusted RIC Capped Index (USD Hedged) during the 36 months ended May 31, 2017 was 2.96%, while the volatility of the Bloomberg Barclays U.S. Aggregate Float Adjusted Index was 3.00%.

Source: Vanguard.

Managing active funds with patience

When it comes to active management, Vanguard is patient, not passive.

Vanguard’s oversight and manager search team, which is responsible for overseeing the 27 independent firms that manage many of our actively managed funds, understands that even the best active manager may suffer long stretches of underperformance.

However, it’s not a static approach to oversight. We’re constantly looking for new opportunities to improve investor outcomes. Such was the case with recent manager changes made to Vanguard Explorer™ Fund, a multimanager U.S. small- and mid-cap growth equity fund with $12.4 billion in total net assets as of June 30, 2017.

Believing we had found an opportunity that would benefit investors, we announced the addition of a new manager to the fund in March 2017 and the departure of two existing managers. The transition in Explorer Fund’s advisors is a reflection of the focused, qualitative process we employ to pursue positive outcomes for investors across our actively managed portfolios. And it reinforces the role active management can play in a well-diversified defined contribution (DC) investment lineup.

Active is part of Vanguard’s heritage

While Vanguard is well known for its role in developing indexing as an investment management approach, active management has been a big part of the firm’s business since its founding in 1975. As of December 31, 2016, Vanguard had $1.1 trillion in assets under active management—including $533 billion managed by external advisors.1

“The three keys to active management success are talent, cost, and patience,” said Dan Newhall, a principal in Vanguard Portfolio Review Department who heads a team of more than 20 analysts responsible for investment oversight and manager search. “If we get those right, long-term performance follows.”

Today internal and external advisory firms manage more than 50 U.S.-domiciled Vanguard funds. The Portfolio Review team sees 150 to 200 firms per year as part of its global search process—looking both at internal and external talent—but has historically made advisor changes infrequently. The average tenure of Vanguard’s external advisors today is about 14 years.

The Explorer Fund: A case study

Starting in 2013, when the fund had six advisors, the Portfolio Review team identified opportunities to add two managers: Stephens Investment Management Group, LLC, that year, and ArrowMark Partners, in 2014.

The changes added high-quality, complementary managers that gave Vanguard time to evaluate the existing managers. Over the next two years, the number of advisors decreased to six. In March 2017, Vanguard introduced ClearBridge Investments, LLC, in a new advisor relationship and parted ways with two others, reducing the number of advisors to five.

“These changes are about where we see the future of Explorer Fund,” Mr. Newhall said.

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1 Source: Vanguard data as of December 31, 2016. Actively managed assets include fixed income, balanced, and money market funds.
“We have great confidence in this combination of managers and their ability to generate compelling results.”

**How Vanguard’s approach is unique**

Vanguard’s oversight and manager search process is rooted in the evaluation of qualitative factors—broadly defined as firm, people, philosophy, and process. These factors, if correctly identified and analyzed, become the drivers of the desired outcomes—the portfolio characteristics and long-term outperformance.

“We deliberately take our time,” Mr. Newhall said. “We focus on the qualitative drivers. We think long term. Sometimes we have concerns about a manager for a number of years, but we want to be sure we haven’t overlooked something. We want to see if we can mitigate a concern. We’re willing to be patient.”

For a multimanager fund such as the Explorer Fund, the Portfolio Review team examines each manager’s role in the fund. We seek an optimal blend of investment strategies relying on managers with distinct yet complementary approaches. The vetting is intended to find active managers who, over time, can generate long-term excess returns.

“The combination of managers we look for have limited holdings overlap, modest style biases, and, as a result, low correlation of projected excess returns,” Mr. Newhall said. “This approach offers the potential for long-term outperformance and can reduce the variability of excess returns.”

**Practitioner’s perspective:**

**Using active in a DC plan**

The arguments for indexing in DC plans are strong, and Vanguard believes indexed investments should form the core of most DC plans. However, low-cost active investments can serve as a good supplemental tier in your plan lineup if there are particular asset classes where you have a preference for active or if you have a conviction about a specific manager.

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**Vanguard framework for evaluating managers**

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<td>• Limited turnover of key professionals</td>
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<td>• Tenure and experience</td>
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<td>• Proven expertise in subject matter</td>
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<td>• Demonstrated ability to handle large mandates</td>
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<td>• Clear reflection of philosophy and process</td>
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<td>• Characteristics consistent with expectations</td>
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<td>• Risk profile is aligned with investment strategy</td>
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<td><strong>Performance</strong></td>
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<td>• Long-term history of competitive results versus benchmarks and peers</td>
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<td>• Performance consistent with investment approach</td>
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“What we believe is critically important is that the actively managed investments be low cost,” said Michael Palazzi, a senior investment consultant in Vanguard Defined Contribution Advisory Services.

Costs can be a key factor in whether a fund generates excess returns over longer time periods (see Figure 1). According to Vanguard research, a rigorous qualitative manager oversight process combined with low cost can position active investors for long-term success.³

Also important are developing a strong understanding of the manager’s approach and setting reasonable performance expectations for the given strategy, Mr. Palazzi said. Such ongoing oversight helps the plan sponsor view the manager’s process through a fiduciary lens.

Vanguard’s approach to active management can give plan sponsors an additional layer of comfort.

“We have a diligent approach well-grounded in experience,” Mr. Palazzi said.

A multimanager arrangement often results in added diversification and lower volatility within an asset class, because different managers will react differently to market conditions and find unique investment opportunities. “You’re diversifying managers, which can serve to dilute single-manager risk,” he said ●

As rates change, the role of bonds remains the same

By Bill McNabb

For many people, including me, falling interest rates have been the general trend in the bond market throughout our working lives. At the beginning of 1983—the year I graduated from business school—the yield of the benchmark 10-year U.S. Treasury note stood at more than 10%. It was less than 2.5% at the beginning of 2017.

It’s not surprising then that, because bond prices move in the opposite direction from rates, plan participants may worry about the effect of bond returns on their bottom line.

Midway through 2017, Federal Reserve policymakers raised their target for the federal funds interest rate for the fourth time since December 2015. The yield of the 10-year U.S. Treasury remained less than 2.5%, but many investors wonder how long that will last.

With economic activity picking up, wages starting to move higher, and inflation coming off recent lows, the Fed has signaled that further gradual increases are likely through 2018. The perceived pro-growth stance of the new U.S. administration also has played a role in framing a case for higher rates.

Short-term pain, longer-term gain
If interest rates shoot up, the market value of bonds will drop sharply, with prices falling to bring yields in line with the new, prevailing higher rates. That’s the potential short-term pain. But long-term investors should actually want rates to go up. The opportunity to reinvest interest income (and the proceeds of maturing bonds) into higher-yielding bonds can work to their advantage over time.

There’s a simple—though imperfect—rule of thumb that helps make clear this point. If the time frame of your investing goal exceeds the time frame of your bond portfolio (a medium-term goal matched with short-term bonds, or a long-term goal paired with bonds not quite as long term), rising rates will work out in your favor, maybe decidedly so.

Think of it this way: If you have a big cash need in the near future—say, a tuition bill coming due in a few years—and you own bonds that are long-term in nature, this time-frame mismatch could spell trouble if rates rise sharply; you’d be selling bonds that would be worth less.

But if you’re saving to retire 10 or 15 years down the road, and rates are steadily rising, over time you’ll be earning higher and higher yields. Josh Barrickman, our head of fixed income indexing for the Americas, calls it “the virtuous cycle of compounding interest at a higher rate.”

The bottom line is, you can end up better off than if rates hadn’t risen because you’re earning more income, which over time more than washes away any price hit.
Beware of short-sighted, short-term moves
This logic can be difficult for plan participants to grasp, tempting anxious bond investors to make drastic shifts to lessen the immediate pain of rising rates. Unfortunately, such moves can backfire.

Taking shelter in short-term bonds, for example, might seem like a good idea. Their prices generally hold up better than those of longer-term bonds in a rising rate environment. But they also offer less income.

For example, when the market started worrying about rising rates in 2010, moving into short-term securities—and staying there—would have proved costly. Through 2016, those securities returned roughly half of what the broad U.S. bond market did.

Favoring high-yield bonds is another tack some investors take, expecting higher income to help cushion price declines. High-yield securities, however, typically perform best when stocks are rising, making them unlikely to zig when stocks zag.

We saw clear evidence of the correlation between stocks and high-yield bonds in the frantic markets following the United Kingdom’s vote to leave the European Union last year. From June 23 to June 27, 2016, both U.S. stocks and U.S. high-yield bonds lost ground. The broad U.S. bond market, meanwhile, climbed 1.2% as investors sought a safe haven.

A portfolio is more than the sum of its parts
It’s important plan participants understand that different assets have different roles to play in a balanced and diversified portfolio. Stocks are valuable because they can produce higher returns over time, while bonds can provide a crucial counterweight to the volatility of stocks.

Perhaps the most important thing to keep in mind about bonds is that although their prices can fluctuate, they remain “fixed income” securities. Barring default, you can be certain of getting income until the bonds mature. It’s that income that drives returns for patient bond investors who resist the urge to jump in and out of the market.

A lot has changed since I first started following the bond market, but the important role that bonds can play in a balanced and diversified portfolio hasn’t •

Bill McNabb
Mr. McNabb is chairman and chief executive officer of Vanguard.
Bill McNabb

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For more information about Vanguard funds, visit institutional.vanguard.com or call 800-523-1036 to obtain a prospectus or, if available, a summary prospectus. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectus; read and consider it carefully before investing.

All investing is subject to risk, including the possible loss of the money you invest. Prices of small- and mid-cap stocks often fluctuate more than those of large-company stocks.

Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments (stocks) to more conservative ones (bonds and short-term reserves) based on its target date. An investment in a target-date fund is not guaranteed at any time, including on or after the target date.

Bonds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer’s ability to make payments.

Investments in bond funds are subject to interest rate, credit, and inflation risk. Currency hedging transactions may not perfectly offset a fund’s foreign currency exposures and may eliminate any chance for a fund to benefit from favorable fluctuations in those currencies. The fund will incur expenses to hedge its currency exposures.

Diversification does not ensure a profit or protect against a loss.

Past performance is no guarantee of future results.